CLIFFORD SWAN
The Investment Counselor
Serving Clients Since 1915 | Second Quarter 2013

Food and Poison

by Maye Albanez, CFA, CIC

Clifford Swan has always looked to equities as the major source for growth in our clients' portfolios. We understand that though stocks can be volatile over the short term, they represent the opportunity to retain the real value of portfolio assets over the long term. Bonds, on the other hand, as our own website reads, are "best used as a capital preservation tool, providing higher income levels and increasing portfolio stability." We expect bonds to be less volatile than stocks, and we look to them to provide a much needed anchor during uncertain times.

In recent years, the bond market has forced us to look at bonds from a different angle than we have in decades. Bond yields, as measured by the ten-year U.S. Treasury bond, have not been this low since the 1940s. They peaked in the 1980s in the mid-teens and have been declining ever since (see graph, right). We have reached a point where the current rate of inflation is actually higher than the interest rate on the ten-year U.S. Treasury bond, which is not a good recipe for the long term.

There are a number of possible explanations for these historically low yields. The most obvious one is our slow economic growth coupled with the calculated actions by the Federal Reserve to reignite the economy. In addition, the memory of sharp stock market declines remains fresh in many investors' minds, particularly as the equity markets continue to reach new highs. A large number of baby boomers, who are at or approaching retirement age, are flooding the bond markets in search of stability for their portfolios. All of these factors have fueled the bond market and resulted in rock-bottom yields. Many investors realize that today's bond yields are much too low to provide the income they require, and as a result, are desperately seeking solutions to boost their low-yielding portfolios.

Ten-Year U.S. Treasury Bond Historical Yields

Source: Compustat and Goldman Sachs Global ECS Research

I am reminded of a short piece published in 1925 by our founder, A.M. Clifford, entitled *Food and Poison*. He wrote, "such risks are Food for a few wealthy men who delight in large hazards. They can afford to lose. Averaging their Profits and Losses they still make money. But these risks are Poison for the man of moderate means and heavy family responsibilities. Of course the profits are tempting, but he can't afford to lose!"

Applying those same words to today's environment, we can say that although it may be perfectly appropriate for some of our clients to take some calculated risks while reaching

Food and Poison
continued on page 2

Food and Poison

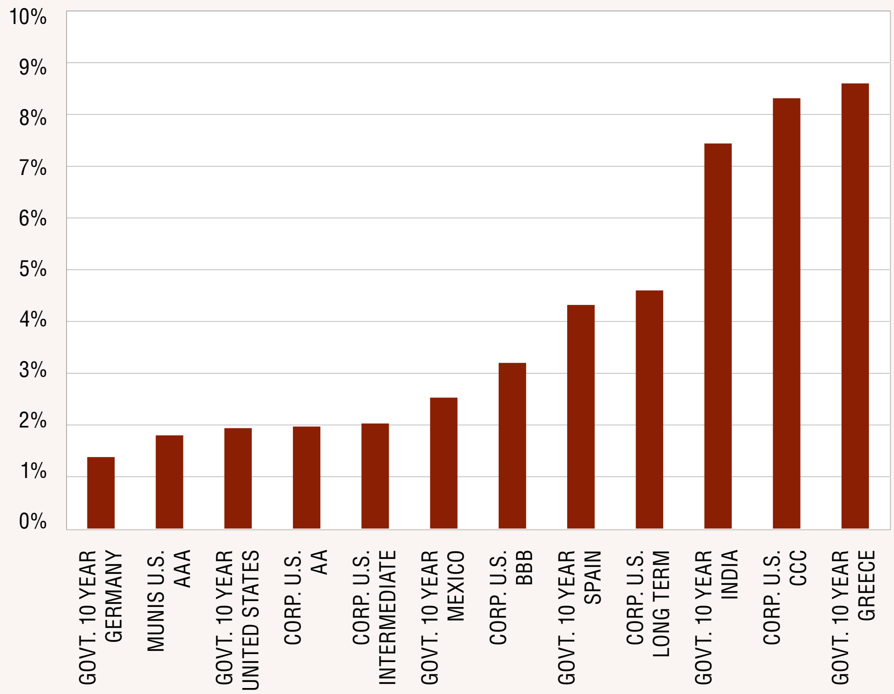
continued from page 1

for yield in this market, for many others, it clearly is not appropriate. As investment counselors, the most important aspect of our job is to know our clients well and to understand their financial circumstances even better, and, based on that, to be clear about the level of risk each of them can or cannot afford to take.

The ten-year U.S. Treasury bond yield stands around 2% today (see graph, right). If a bond or bond fund yields significantly more than that, there likely is a good reason for it. It is important to understand that reason, and more importantly, prior to purchasing it, to understand what the cost of owning it may be down the road.

Consider some of the factors that can affect bond yields:

Bond Yields Today



Sources: Bloomberg and Wall Street Journal

Interest rates

Interest rates and bond prices move in opposite directions. When interest rates decline, as they have since the 1980s, bond prices go up. When interest rates rise, bond prices decline. It should be obvious that interest rates have a greater chance of rising than declining today, which also means that bond prices have a greater chance of declining than rising. Less obvious is exactly when that change will occur.

> **As investment counselors, the most important aspect of our job is to know our clients well and to understand their financial circumstances even better, and, based on that, to be clear about the level of risk each of them can or cannot afford to take.**

Duration

Duration measures the price sensitivity of bonds given changes in interest rates. The longer the maturity of a bond, the greater its duration, and the longer its duration, the greater its sensitivity to changes in interest rates. For example, if Bond #1 has duration of 6 and interest rates rise by 2%, the price of Bond #1 will decline by 12%. On the other hand, if Bond #2 has duration of 2 and interest rates rise by the same 2%, the price of Bond #2 will only decline by 4%. In this environment, higher yields generally come from longer duration bonds, and that translates to greater declines in bond prices when interest rates rise.

Quality

Many bonds are rated by credit agencies in terms of quality, and based on those ratings, are primarily classified as "investment grade" or "below investment grade" with many more sub-classifications in between. The purpose of classifying them is to help investors understand the credit worthiness of these bonds and their ability to repay investors who buy them. As with FICO scores, those of us with lower scores pay higher interest rates on our mortgages while those of us with higher scores pay lower rates. So, higher bond yields in this environment generally mean lower quality, and lower quality could mean a higher probability of default down the road.

Leverage

Some managers of bond funds use leverage in order to increase income payouts. In periods like today, some managers borrow money at low short-term rates and purchase longer-term or lower-quality bonds to attain higher yields. When rates increase, borrowing costs will rise, the value of bonds will drop, and when declines materialize, managers may be forced to sell additional bonds at declining values

Food and Poison

continued on page 3

Food and Poison

continued from page 2

given the leverage. As long as borrowing rates remain stable or continue to decline, gains can be, and have been, magnified. When rates increase, however, losses will be amplified as well. This phenomenon is at the core of leveraged investments. All other characteristics the same, leveraged funds carry significantly more risk than unleveraged ones. In an environment where rates are expected to rise and prices are expected to decline, it could prove dangerous to own them.

Stock Ownership

Many investors and bond funds have increased their allocation to stocks in an effort to boost income. In the current investing environment, it is not difficult to identify stocks offering higher yields than short or intermediate bonds. However, owning more stocks in a portfolio today than one otherwise would for the purpose of boosting income could mean increased price volatility down the road. Given the strength of the stock market in recent months, price declines in a market pullback should not come as a surprise to anyone.

Our goal here is to educate you on some of the risks behind what might appear to be very attractive investments, on the surface. It is not to scare or be critical of those who have reached for yield in an environment that does not reward savers, or where inflation is higher than the yield on high-quality bonds. We are painfully aware that if we do not take some risk in this environment, we could experience a decline in the real value of our money. Having said that, recall *Food and Poison*. Some of us can justify taking higher risks and can afford to lose part of our gains or more; others of us cannot and should not. Like most things in life, it is all a matter of degree—in this case, degree of risk. Consider your own reasons for owning bonds. Are bonds meant to be the anchor of your portfolio during volatile times, or not? Knowing the answer today to that question may keep you from being disappointed or distressed when interest rates reverse their current course.

In addition to the words quoted earlier from *Food and Poison*, A. M. Clifford also wrote that “one of the duties of the investment counselor is to guide his client into only the securities for which he is financially and temperamentally best fitted.” We often find that, in times like these, our commitment to provide independent, disinterested advice is most valued. ◆

We are painfully aware that if we do not take some risk in this environment, we could experience a decline in the real value of our money.

Breaking News for Municipal Bonds

by Randall L. Zaharia, CFA

When conducting our due diligence into the municipal bonds we purchase on behalf of our clients, the reliance on municipal insurance is minimal in Clifford Swan’s evaluations, especially since the 2008 financial crisis. Prior to the 2008 economic meltdown, there were a handful of “AAA” rated municipal bond insurers, including an insurer named MBIA Corp, the parent company of National Public Finance Guaranty, a municipal bond subsidiary (known also as “National Re”). Today, there are no AAA rated bond insurers. Nonetheless, for many of the National Re insured bonds now held, the credit quality has just improved. MBIA Corp. has settled with both Bank of America ($1.7 billion) and with Societe Generale ($0.35 billion), and, as a result of these settlements, MBIA will be repaying a $1.6 billion loan that the corporation secured from National Re. The payoff of this loan will strengthen the financial resources of the National Re subsidiary. As a result, S&P upgraded National Re’s credit rating to “A” from “BBB”, and Moody’s upgraded it to “Baa1” while maintaining its positive upgrade watch. We anticipate that National Re will probably have an “A” rating from both Moody’s and S&P within the next few quarters. While we will continue to rely on our own in-depth study of bond issuers, credit-worthy insurers can only increase our peace of mind. ◆

2013 Tax Rates and Charitable Giving

by Kenneth H. Dike, Esq., CPA, CLPF

Beginning in 2013, changes in the tax code increased the tax benefits of charitable giving by raising the tax rates assessed "high-income" taxpayers. A tax on investment income, increased tax rates on capital gains and adjusted gross income (AGI), and increased transfer tax rates will serve to lower the after-tax cost of giving.

The Health Care and Education Reconciliation Act of 2010, which amended the Affordable Care Act, creates a 3.8% tax on net investment income, including capital gains, for individuals with AGIs over $200,000 and those filing joint returns with an AGI exceeding $250,000. The American Taxpayer Relief Act of 2012 increases the maximum tax rate applied to capital gains (20%) and other, non-capital gain, ordinary income (39.6%) for single taxpayers with an AGI over $400,000 ($450,000 if joint return).

The maximum transfer tax rate will increase to 40% on taxable estates and non-charitable transfers. The transfer tax exemption remains at the 2010 and 2011 amount of $5 million indexed for inflation beginning in 2012, and any unused exemption can be used by the surviving spouse (see table, below).

When appreciated property is donated to charity, the donor: (1) avoids paying tax on the gain that would be realized had the donor sold the property, (2) is entitled to a charitable deduction for the value of the property donated, and (3) removes the property from their estate without being subject to gift tax.

Let us look at an example. Assuming all AGI and estate value floors have been met, a 2013 donation of stock worth $100,000 that was purchased several years ago for $60,000 would: (1) avoid $9,520 in capital gain and investment income tax, (2) provide the donor with a $100,000 charitable deduction that would reduce tax on ordinary income by $39,600, and (3) avoid potential transfer tax of $40,000. The total tax savings of $89,120 from a 2013 stock gift is about 17% more than the tax savings generated by a 2012 donation of the same stock.

Recent gains in the stock and real property markets have increased the opportunities for tax advantaged charitable giving whether the gift is outright or in the form of a split-interest agreement such as a charitable trust. A split-interest agreement is used when the donor is not ready to part with the entire interest in the donated property. The donor can retain the rights to periodic payments with the remainder going to charity (charitable remainder trust), or the periodic payments can go to charity with the remainder reverting back to the donor (charitable lead trust).

Split-interest trusts have two interests: an income interest and a remainder interest. The income interest is the right to receive periodic payments during the life of the trust and the remainder interest is the right to receive whatever remains in the trust upon its termination. The amount of the periodic payments can be a percentage of the trust's periodic market value, as in a unitrust, or the payments could be fixed in amount throughout the life of the trust, as in an annuity trust.

The main difference in the tax implications of an outright gift versus a split-interest trust is how the charitable deduction is calculated. The tax deduction from an outright gift is the market value of the property gifted, while the tax deduction from a split-interest trust is the present value of the remainder interest, or lead trust income interest, held by charity. The donor still avoids paying capital gain tax on the alternative of selling the appreciated property, and the property is removed from the donor's estate without being subject to transfer tax.

The variables used in the present value calculation for gifts to charitable split-interest trusts are: (1) the amount of

2013 Tax Rates continued on page 5

Maximum Tax Rates

	2012	2013
Net Investment Income	0%	3.8%
AGI exceeding $200,000/$250,000 for single/joint returns		
Capital Gain	15%	23.8%
AGI exceeding $400,000/$450,000 for single/joint returns		
Rate for 2013 = 20% capital gain tax plus 3.8% tax on investment income		
Ordinary Income	35%	39.6%
AGI exceeding $400,000/$450,000 for single/joint returns		
Excludes capital gain income that is taxed at the lower rates noted above		
Taxable Transfers	35%	40%
Estates and non-charitable gifts exceeding the exemption by at least $1 million		
Exemption: 2012 estate tax returns= $5.12 million, 2013= $5.25 million		

2013 Tax Rates

continued from page 4

periodic payments prior to termination, (2) the expected duration of the trust, often a life expectancy estimate, and (3) the monthly IRS-proscribed discount rate which is currently at a historic low. Holding the other variables constant, as the discount rate declines, so does the calculated present value of the remainder interest. Therefore, low discount rates reduce the charitable deduction for charitable remainder trusts (charity holds the remainder interest) and increase the charitable deduction for charitable lead trusts (charity holds the income interest).

Changes in the IRS discount rate have little effect on the present value calculation for unitrusts but a significant effect on the present value calculation for annuity trusts, including whether a charitable remainder annuity trust will even qualify for any charitable tax deduction.

Both charitable remainder unitrusts and charitable remainder annuity trusts must meet a “10% minimum remainder value” test and a “5% probability of corpus exhaustion” test. The present value of the remainder interest (charitable deduction) from a charitable remainder trust must be at least 10% of the total trust value, and there must be no more than a 5% chance that a charitable remainder annuity trust will use all of its assets for the periodic payments, which would leave nothing for the charity upon its termination. In addition, the payout rate for charitable remainder trusts (periodic payments prior to termination) must be no less than 5%. Given these requirements, the minimum age for a life-beneficiary of a charitable remainder annuity trust was 75 when the IRS discount rate was 1.2% in May 2013 and 65 when the discount rate was 3.0% in May 2011. These tests only apply to charitable remainder trusts and are not required for charitable lead trusts. In a charitable lead trust, the charity gets paid first and there is little chance that the charity will receive nothing from the trust. Also, unlike a charitable remainder trust and the 5% minimum payout, there is no minimum payout requirement for charitable lead trusts.

Recent gains in the stock and real property markets have increased the opportunities for tax advantaged charitable giving . . .

Combined with increased tax rates, the recent gains in the stock and real estate markets make outright charitable gifts and charitable remainder unitrusts more attractive than they have been in several years. Charitable lead trusts also benefit from these factors as well as the historically low discount rates used to value the lead trust charitable deduction. Whether this environment actually translates into increased giving is anyone’s guess, since the tax benefit of charitable giving is only part of the story. The after-tax cost of giving may be reduced by tax incentives but almost never eliminated. Charitable giving is ultimately driven by the generosity of donors who voluntarily give a portion of their wealth in support of a variety of charitable causes with no expectation of any personal financial reward. ◆

Market Commentary

by Ralph E. Weil, CFA

At Clifford Swan, we are fundamental investors, meaning we examine companies from the ground up. We study financial statements from companies, review their industries, and assess where the company stands in its sector. We attempt to buy great companies at reasonable prices and would like to be long-term holders of these positions. One of the financial statements we put a lot of emphasis on is the Balance Sheet because it gives us a good idea of the condition of the company. This helps us understand if the company will be strong enough to survive future economic cycles.

When we look at the equity and fixed income markets, we build our own Balance Sheet of positives and negatives to help us weigh signs for future market performance. As you might know, a balance sheet has three parts: Assets (positives), Liabilities (negatives) and Capital. In our weighing process, Capital has zero value, so we are evaluating only the positives and negatives. For this market outlook, I will review how we see the current Balance Sheet and what we believe the trend will be over the next twelve to eighteen months.

Let’s start with the positives. On a nominal basis, the equity market as measured by the S&P 500 and the Dow Jones Industrials has achieved new highs. On an adjusted-for-inflation basis, the market is below where it was in 2000 and 2007. Even so, the new nominal high is a positive.

Corporate earnings and profit margins along with cash flows are also at all-time highs. Corporations

Market continued on page 6

Market continued from page 5

are in a strong position to invest in future growth and also return more of that cash to shareholders in the form of dividends or share buybacks. A large number of companies have already done this, and we expect the list to grow. Even with these programs in place, cash continues to grow on corporate balance sheets. In addition to using the free cash flow for dividends and share buybacks, managements have been improving their balance sheets by paying down debt and improving other ratios we review.

With interest rates and borrowing costs basically at all-time lows, companies that need to raise cash for whatever purpose can borrow the money very cheaply. A good example of this is the recent debt offering from Apple, Inc. Even though it has a huge stock of cash, for tax reasons Apple decided to sell $17 billion in bonds to the public at a very low average interest rate to raise capital. Low rates also help the consumer finance new purchases and investments, with assurances from the Federal Reserve that short-term interest rates will remain near zero into 2014. The low cost of funds has helped bring about a good recovery in housing, and we are happy to say that, so far, individuals are using the borrowing capacity judiciously.

The U.S. economy continues to improve, but at a slow pace. This in and of itself does bring up some concerns, but, overall, growth is good news. The balances of the world economies are mixed, at best, with a few countries growing while others are not. The real positive here is that the pressure of inflation is almost nonexistent in the near term.

One more positive area for review is stock market valuations. When we look at price-to-earnings, price-to-cash-flow, price-to-book-value, and most other valuation metrics, we do not see any that are way out of line. There is clearly not anything like we saw in 2000 or 2007. Considering where interest rates are today, the current dividend yield on common stocks certainly looks attractive.

The things that could put pressure on the market and the economy are carried on the Liability side of the Balance Sheet, and are generally being ignored by the market currently. First is the economy. While noted on the positive side of our Balance Sheet from the inflation point of view, the slow growing economy is also a Liability. Once we get past the sectors that benefit most from low interest rates and easy credit, we see a gap growing wider between those direct beneficiaries and all of the others. Rate of growth, while still positive for the overall economy, is either negative or turning down in most sectors except for housing, autos, and a few other related areas. Wholesale inventories rose more than expected in March, while wholesale sales fell 1.6%, the largest decline in four years. In addition, commodity prices continue to decline because of the slowdown in demand, reflecting weak industrial production around the world. The large amount of cash on corporate balance sheets is also a two-edged sword. One of the main reasons that cash is accumulating is that managements are reluctant to put some of that money to work for expansion of existing business. The most often stated reason is the uncertainty of the policies emanating from Washington. The sooner things get resolved in the nation's capital, the better off the economy will be.

The job picture is not great either. Yes, the unemployment rate is down, but that is more a function of people dropping out of the labor market than of more jobs being created. It also seems that a lot of the jobs being filled are for lower skilled positions at lower pay scales. As proof of this, the median household income has declined 5.6% since the recovery began in June 2009.

We know that we could expand our Balance Sheet by adding more positives and negatives to the list, but they may not change the conclusion one way or the other. So far this year, we have seen a 15% plus move to the upside in the equity markets as measured by the usual benchmark averages. When we evaluate the upsides against the downsides that have been discussed, we see an almost equal weighting. Looking forward for the remainder of the year, we expect market moves, either upward or downward, to be small, with a high probability that we will end up at today's levels. This does not mean that there are no new investment opportunities over the rest of the year. We continue to review existing holdings and to search for companies that offer future, if currently limited, gains. ◆

CLIFFORD SWAN
INVESTMENT COUNSEL

Professionals

Maye Albanez, CFA, CIC
S. David Andrew
Carolyn S. Barber, CFA, CIPM, CIC
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Michael G. Davis, CFA, CIC
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
Anil Kapoor, CFA
Maxwell R. Pray, CFA
Terrell H. Price
Linda Davis Taylor
Ralph E. Weil, CFA
Bruce C. White
Lloyd Wong, CFA
Randall L. Zaharia, CFA

Offices

Pasadena
200 South Los Robles, Suite 320
Pasadena, CA 91101
626.792.2228 | 626.792.2670 FAX

Costa Mesa
650 Town Center Drive, Suite 845
Costa Mesa, CA 92626
714.846.2851 | 714.668.9302 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

www.cliffordswan.com